NO. 18628

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

WILL FLITCROFT and AGNES D. FLITCROFT,

Appellants,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

BRIEF FOR APPELLANTS

ON PETITION
FOR REVIEW OF DECISION OF
THE TAX COURT OF THE UNITED STATES

ERNEST R. MORTENSON
EUGENE HARPOLE

961 East Green Street
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Attorneys for Appellants

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OPINION BELOW

The Opinion of the Tax Court was filed on October 9, 1962 and its decisions based upon said Opinion and whose review is sought, were entered on December 18, 1962, and December 20, 1962, respectively (R. 217-247, 258-261).

JURISDICTION

The Tax Court had jurisdiction of this matter under §7442 (26 USCA 7442) and §6213 of the Internal Revenue Code of 1954 (26 USCA 6213). This Court has jurisdiction under §7482 of the Internal Revenue Code of 1954 (26 USCA 7482).

This Petition for Review (R. 262-266) involves deficiencies in the petitioners' Federal income taxes for the calendar years 1954, 1955 and 1955, respectively (R. 16). The petitioners, Will Flitcroft and Agnes D. Flitcroft, were and are husband and wife with a place of residence in Los Angeles County, State of California (R. 55). They filed joint Federal income tax returns for the calendar years 1954, 1955 and 1956, with the District Director of Internal Revenue at Los Angeles, California, on the respective dates of April 15, 1955, April 16, 1956 and April 15, 1957 (R. 55).

On March 11, 1959, the Commissioner of Internal Revenue mailed to the taxpayers by registered mail a Notice of Deficiency covering the calendar years 1953 and 1954 (R. 16). The taxpayers filed a Petition for Redetermination with the Tax Court on May 4, 1959 (R. 9).

On August 5, 1960, the Commissioner of Internal Revenue mailed to the taxpayers by registered mail a Notice of Deficiency covering the calendar years 1955 and 1956 (R. 36). The taxpayers filed a Petition for Redetermination with the Tax Court on September 6, 1960 (R. 31).

On October 9, 1962, the Tax Court filed its Opinion covering both Dockets No. 80074 and No. 88894 (R. 217). The Tax Court's decision covering the year 1954, whose review is sought, was entered December 18, 1962 (R. 258). Its decision covering the years 1955 and 1956, whose review is also sought was entered on December 20, 1962 (R. 260).

The case is brought to this Court by a Petition for Review

filed with the Tax Court on March 11, 1963 (R. 262). On March 11, 1963, the petitioners filed with the Clerk of the Tax Court and served upon the Attorney General, a Statement of Points Upon Which They Intend to Rely in this Review (R. 267).

Petitioners have designated the entire record of all the proceedings and evidence including exhibits as the record on review of the decision of the Tax Court (R. 270).

STATUTES AND REGULATIONS INVOLVED

Section 191, Internal Revenue Code of 1939:

"FAMILY PARTNERSHIPS:

"In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. The distributive share of a partner in the earnings of the partnership shall not be diminished because of absence due to military service. For the purpose of this section, an interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market

value of the purchased interest shall be considered to be donated capital. The 'family' of any individual shall include only his spouse, ancestors, and lineal descendants, and any trust for the primary benefit of such persons."

Section 704 (e)(1)(2)(3), Internal Revenue Code of 1954:

"(e) Family Partnerships. -

"(1) Recognition of interest created by purchase or gift. -

"A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

"(2) Distributive share of donee includible in gross income. -

"In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. The distributive share of a partner in the earnings of the partnership shall not be diminished because of absence due to military service.

"(3) Purchase of interest by member of family. -

"For purposes of this section, an interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The 'family' of any individual shall include only his spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons."

Section 162 (a)(3), Internal Revenue Code of 1954:

"(a) In General. - There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including -

"(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

Section 673 (a), Internal Revenue Code of 1954:

"REVERSIONARY INTERESTS.

"(a) General Rule. - The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom if, as of the inception of that portion of the trust, the interest will or may reasonably be expected to take effect in possession or enjoyment within 10 years

commencing with the date of the transfer of that portion of the trust."

Section 676 (a), Internal Revenue Code of 1954:

"POWER TO REVOKE.

"(a) General Rule. - The Grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under any other provision of this part, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a non-adverse party, or both."

Treasury Regulations 1.162-1:

"§1.162-1 Business expenses - (a) In general. Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except items which are used as the basis for a deduction or a credit under provisions of law other than section 162. The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income. See §1.61-3(a). Among the items included in business expenses are management expenses, commissions (but see section 263 and the regulations thereunder), labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business

(see §1.162-2), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property."

Treasury Regulations 1.704-1(e)(vii):

"(vii) Trustees as partners.

A trustee may be recognized as a partner for income tax purposes under the principles relating to family partnerships generally as applied to the particular facts of the trust-partnership arrangement. A trustee who is unrelated to and independent of the grantor, and who participates as a partner and receives distribution of the income distributable to the trust, will ordinarily be recognized as the legal owner of the partnership interest which he holds in trust unless the grantor has retained controls inconsistent with such ownership. However, if the grantor is the trustee, or if the trustee is amenable to the will of the grantor, the provisions of the trust instrument (particularly as to whether the trustee is subject to the responsibilities of a fiduciary), the provisions of the partnership agreement, and the conduct of the parties must all be taken into account in determining whether the trustee in a fiduciary capacity has become the real owner of the partnership interest. Where the grantor (or person amenable to his will) is the trustee, the trust may be recognized as a partner only if the grantor (or such other person) in his participation in

the affairs of the partnership actively represents and protects the interests of the beneficiaries in accordance with the obligations of a fiduciary and does not subordinate such interests to the interests of the grantor. Furthermore, if the grantor (or person amenable to his will) is the trustee, the following factors will be given particular consideration:

"(a) Whether the trust is recognized as a partner in business dealings with customers and creditors, and

"(b) Whether, if any amount of the partnership income is not properly retained for the reasonable needs of the business, the trust's share of such amount is distributed to the trust annually and paid to the beneficiaries or reinvested with regard solely to the interests of the beneficiaries."

Treasury Regulations 118, §39.22(a)-21(c):

"Reversionary interest after a relatively short term. (1) Income of a trust is taxable to the grantor where the grantor has a reversionary interest in the corpus or the income therefrom which will or may reasonably be expected to take effect in possession or enjoyment:

"(i) Within 10 years commencing with the date of the transfer, or * * * * "

Section 2250, Civil Code of California:

"Who are trustees within scope of this chapter.

"The provisions of this chapter apply only to express trusts, created for the benefit of another than the trustor,

and in which the title to the trust property is vested in the trustee; not including, however, those of executors, administrators, and guardians, as such."

Section 2280, Civil Code of California:

"REVOCATION OF TRUSTS.

"Unless expressly made irrevocable by the instrument creating the trust, every voluntary trust shall be revocable by the trustor by writing filed with the trustee. When a voluntary trust is revoked by the trustor, the trustee shall transfer to the trustor its full title to the trust estate. Trusts created prior to the date when this act shall become a law shall not be affected hereby."

Section 1614, Civil Code of California:

"WRITTEN INSTRUMENT PRESUMPTIVE EVIDENCE OF CONSIDERATION.

"A written instrument is presumptive evidence of a consideration."

Section 1689, Civil Code of California:

"WHEN PARTY TO A CONTRACT MAY RESCIND.

"A party to a contract may rescind the same in the following cases only:

"1. If the consent of the party rescinding, or of any party jointly contracting with him, was given by mistake, or obtained through duress, menace, fraud, or undue influence, exercised by or with the connivance of the party as to whom he rescinds, or of any other party to the

contract jointly interested with such party;

"2. If, through the fault of the party as to whom he rescinds, the consideration for his obligation fails, in whole or in part;

"3. If such consideration becomes entirely void from any cause;

"4. If such consideration, before it is rendered to him, fails in a material respect, for any cause;

"5. By consent of all the other parties; or

"6. Under the circumstances provided for in sections 1785 and 1789 of this code."

Section 1691(2), Civil Code of California:

"RESCISSION, HOW EFFECTED.

"2. He must restore to the other party everything of value which he has received from him under the contract; or must offer to restore the same, upon condition that such party shall do likewise, unless the latter is unable or positively refuses to do so."

Section 3399, Civil Code of California:

"WHEN CONTRACT MAY BE REVISED.

"When, through fraud or a mutual mistake of the parties, or a mistake of one party, which the other at the time knew or suspected, a written contract does not truly express the intention of the parties, it may be revised, on the application of a party aggrieved, so as to express that intention, so far as it can be done without prejudice to

rights acquired by third persons, in good faith and for value."

Section 1060, California Code of Civil Procedure:

"DECLARATORY RELIEF.

"Any person interested under a deed, will or other written instrument, or under a contract, or who desires a declaration of his rights or duties with respect to another, or in respect to, in, over or upon property, or with respect to the location of the natural channel of a watercourse, may, in cases of actual controversy, relating to the legal rights and duties of the respective parties, bring an action in the superior court for a declaration of his rights and duties in the premises, including a determination of any question of construction or validity arising under such instrument or contract. He may ask for a declaration of rights or duties, either alone or with other relief; and the court may make a binding declaration of such rights or duties, whether or not further relief is or could be claimed at the time. The declaration may be either affirmative or negative in form and effect, and such declaration shall have the force of a final judgment. Such declaration may be had before there has been any breach of the obligation in respect to which said declaration is sought."

Section 1061, California Code of Civil Procedure:

"POWER NOT EXERCISED WHEN.

"The Court may refuse to exercise the power

granted by this chapter in any case where its declaration or determination is not necessary or proper at the time under all the circumstances."

Section 1962(2), California Code of Civil Procedure:

"SPECIFICATION OF CONCLUSIVE PRESUMPTIONS.

"The following presumptions, and no others, are deemed conclusive:

"2. The truth of the facts recited, from the recital in a written instrument between the parties thereto, or their successors in interest by a subsequent title; but this rule does not apply to the recital of a consideration."

Section 1963(39), California Code of Civil Procedure:

"DISPUTABLE PRESUMPTIONS.

"39. That there was a good and sufficient consideration for a written contract."

QUESTIONS PRESENTED

I.

SHOULD THE INCOME OF TRUSTS THAT HAD ALWAYS BEEN FOR A TERM IN EXCESS OF TEN YEARS AND WHICH WERE EXPRESSLY IRREVOCABLE TRUSTS DURING THE CALENDAR YEARS OF 1954, 1955 AND 1956 INVOLVED IN THIS PROCEEDING BE TAXED TO THE GRANTORS OF THOSE TRUSTS?

II.

WERE THE TRUSTS CREATED BY THE TAXPAYERS FOR THEIR TWO CHILDREN, WILLIAM R. FLITCROFT AND JOHNEL ANN FLITCROFT UNDER DATE OF JANUARY 1, 1953 REVOCABLE UNDER THE REVISIONS OF §2280 OF THE CIVIL CODE OF CALIFORNIA?

III.

WAS THE CO-PARTNERSHIP, WESTERN HYDRAULIC AND SERVICE COMPANY, ENTITLED TO DEDUCT THE RENTALS PAID TO A TRUST CREATED BY THE TAXPAYERS FOR THEIR TWO CHILDREN ON OCTOBER 1, 1953 FOR THE USE OF ITS BUSINESS PROPERTY DURING THE CALENDAR YEARS 1954, 1955 AND 1956 FROM THE PARTNERSHIP GROSS INCOME OF THOSE YEARS FOR INCOME TAX PURPOSES?

STATEMENT

The Government conceded and the Tax Court has held that the Commissioner's determination of a deficiency in taxpayers' income taxes for the calendar year 1953 was barred by the statute of limitations when made (R. 218). No issue is presented in this appeal as to the calendar year 1953.

The Commissioner determined a deficiency in the taxpayers' income tax for the calendar year 1954 of $39,281.86 and sent a notice of the deficiency to the taxpayers by registered mail on

March 11, 1959 (R. 16). The Commissioner determined deficiencies in taxpayers' income tax for the calendar years 1955 and 1956 in the amounts of $25,666.01 and $31,047.73, respectively, and sent notice of the deficiencies to the taxpayers by registered mail on August 5, 1960 (R. 36) In the statements attached to the respective deficiency notices the following explanations appear:

> "In the determination of your income it is held that the partnership, transacting business under the fictitious name of Western Hydraulic & Service Company, 1510 West 135th Street, Gardena, California, and allegedly entered into on or about January 1, 1953 by you and Richard H. Miers, as trustees for your minor daughter, Johnel A. Flitcroft, and your minor son, William R. Flitcroft, is not effective for income tax purposes. Accordingly, your unreported distributive share of net earnings from said partnership of $37,232.79 in 1955 and $45,395.93 in 1956 have been included in your returns for the respective taxable years.
>
> "It is also held that the rent paid by the partnership transacting business under the fictitious name of Western Hydraulic & Service Company to the Johnel Ann and William R. Flitcroft Trust, in the amount of $11,520 in 1955 and $11,520 in 1956, is not a deductible business expense of the partnership. Accordingly, these amounts have been included in the earnings of the partnership and in your distributive share of the partnership earnings in the years

1955 and 1956.

"In the distribution shown above, it is held that the income of the Western Hydraulic & Service Company partnership is distributable 50% each to Will Flitcroft and Agnes D. Flitcroft. It is determined that no recognition should be given to the alleged partnership interests of the trusts created for William R Flitcroft and Johnel A. Flitcroft, minor son and daughter of Will Flitcroft and Agnes D. Flitcroft.

"Ordinary net income of the partnership is increased $11,520.00, as a result of a determination that rent in the amount of $11,250.00 paid by the partnership to the Johnel A. Flitcroft and William R. Flitcroft Trust, minor daughter and son of Will Flitcroft and Agnes D. Flitcroft, is not a deductible business expense of the partnership." (R. 37).

The petitions which the taxpayers filed in the Tax Court allege that the Commissioner erred in taxing the entire income of the partnership, Western Hydraulic and Service Company, to them and also in refusing to allow the partnership a deduction for the rent paid to the William R. Flitcroft and Johnel Ann Flitcroft Trust during the taxable years here involved (R. 9-15, 31-34). The Commissioner's answers denied said allegations of error (R. 26-30, 43-44). The Tax Court sustained the Commissioner's determination on both issues (R. 217-247). The taxpayers seek a

review of the Tax Court's decision.

The Tax Court found as facts, that the petitioners, as partners, operated the business of Western Hydraulic & Service Company during the years 1946 through 1952 (R. 219). That Will Flitcroft managed the Company, functioned as Chief of Quality Control, did all of the purchasing of materials, machinery, and tools, did the bidding for customers, and kept up customer relations, as well as supervised production. In the performance of these duties Will Flitcroft worked long hours, six days and sometimes seven days a week (R. 220). Will Flitcroft testified that the long hours of work were breaking down his health (R. 77).

The Tax Court found as a fact that in June, 1952, the petitioner, Will Flitcroft, became acquainted with Richard H. Miers who was then doing a running audit of the partnership's books. About July, 1952, Will Flitcroft engaged Miers to keep the books and records of the partnership at the prevailing fee of $60 per day for his services (R. 220). Will Flitcroft testified that Miers was quite young and a very efficient boy at that time (R. 77). The Tax Court found that after Western Hydraulic engaged Miers to render accounting services for it, petitioner Will Flitcroft and Miers discussed from time to time the advantages which petitioners might derive through the creation of trusts for the benefit of their two minor children and the inclusion of these trusts in the partnership (R. 78). It was the finding of the Tax Court that the petitioners executed an agreement dated December 31, 1952 dissolving the partnership, Western Hydraulic & Service Company, then existing

between the appellants (R. 221). The Tax Court found that the petitioners and Miers, sometime after January 1, 1953, executed two written trust agreements dated January 1, 1953, Article 7 of which provided:

> "This Trust has been accepted by the Trustee and will be administered in the State of California, and its validity, construction and all rights thereunder shall be governed by the laws of that State. If any provision of this Trust Agreement should be invalid or unenforceable, the remaining provisions thereof shall continue to be fully effective." (R. 221).

Will Flitcroft, one of the trustors, and Richard H. Miers, the trustee, each testified that it was decided the Trust Agreements should go into effect as of January 1, 1953 (R. 18, 122). The Tax Court found that the decision to form said two trusts was reached at a meeting held at the petitioners' home in November, 1952, at which the petitioners, their children aged 10 and 12 years, Richard H. Miers and an attorney were present. The Trust Agreements provided that the two trusts should cease and terminate on January 6, 1963 (R. 221, 222).

The Tax Court further found as a fact that at the same time that the Trust Agreements were executed petitioners and Miers, as trustee, for each of the two trusts, executed an agreement entitled "Agreement of Partnership" which agreement stated that it was made the first day of January, 1953 and provided that the name of

the partnership should be Western Hydraulic and Service Company, that the term of the partnership should begin on January 1, 1953 and should end on December 31, 1963 (R. 223). Respondent's counsel stated at the trial that there was no dispute as to the date of the execution of the Partnership Agreement.

Richard H. Miers, the trustee, gave the following testimony concerning the history of the trusts: " * * * so I volunteered my services and Mr. Flitcroft took me up on it. And we devised the trusts, set up the partnership, primarily for expansion purposes so that we could expand the operation. Western Hydraulic was a captive company of Douglas Aircraft at the time, doing better than 99 per cent of their business with the Douglas Aircraft Company and Douglas is a very peculiar company. Like any major prime contractor, if you can't take care of the business that they offer you, then you're sort of low on the totem pole. So we had no alternative excepting to go ahead. And this is how the trusts started and the move to 135th Street came about." (R. 87-88).

The Trust Agreements each recite that the transfers to the trustee were made without any consideration on the trustor's part (Exh. 5, 6).

The Agreement of Partnership provided that the capital contribution should consist of the assets subject to the liabilities as shown on an attached statement of assets and liabilities (Exh. 17).

The Tax Court drew a conclusion of law from the evidence that the transactions were not shams, that independent trustees controlled the trust corpus, and that petitioners recognized the

trusts as partners and gave public notice of such recognition by the filing of a Certificate of Business Fictitious Firm Name listing the trusts as partners. It was further concluded by the Tax Court that the partnership agreement and trust agreements all dated January 1, 1953 were part of the same transaction and were required to be read together and that when this was done there was clearly a transfer of the trust corpus of the two individual trusts to the trustee and the designation of the trust corpus is clear (R. 234). The Tax Court found as a fact that capital was a material income-producing factor in the partnership, Western Hydraulic (R. 225).

Among other facts found by the Tax Court were the following:

Petitioner, Will Flitcroft, had also concluded that it would be advantageous to have Miers do the accounting work for Western Hydraulic and to help operate the business. During the years 1953 through 1956 Miers spent most of his time in connection with the business of Western Hydraulic. He took charge of production control, accounting, contract negotiations, renegotiation of government contracts and cost records. He also handled labor relations for the partnership and served as its controller, as well as working with the sales and engineering departments on the submission of bids for contracts. He hired office personnel and dealt directly with customers of Western Hydraulic (R. 225, 226).

The Tax Court found as a fact that during the years 1953 through 1956 Miers was paid a fee of $60.00 per day or approximately $900.00 per month for the services he rendered Western Hydraulic (R. 226). Miers testified that this was the prevailing

accounting fee at that time (R. 187). Miers is shown by the testimony in the record not to have received any fringe benefits from Western Hydraulic (R. 124). The Trust Agreements (Exhs. 5 and 6, Stip. Facts) did provide in Article VI a fee based on a percentage of the income of the trust for his services (Exhs 5, 6).

The Tax Court concluded as a matter of law that "the evidence failed to show any benefit to petitioners of Miers' work for Western Hydraulic which was different after the creation of the trusts from before. Both before and after the creation of the trusts Miers did work of an accounting nature for Western Hydraulic at a fee of $60.00 per day. The record does not show any other activities engaged in by Miers in connection with the partnership except his consultation on partnership matters with petitioners; there is no evidence to show that such consultations were of any benefit to petitioners or that they were not solely in the interests of the trusts. The evidence shows that the trusts were voluntary express trusts for the benefit of petitioners' minor children. Cf. George S. Gaylord, CA-9 (1946), 153 F. 2d 408, affirming 3 T. C. 281, and Erik Krag (1947), 8 T. C. 1091." (R. 239).

As originally written the Trust Agreements did not expressly provide that the trusts were irrevocable (Exhs. 5, 6). The petitioners have never received any income from the trusts (R. 82, 230).

The petitioner, Will Flitcroft, testified that the two trusts formed on January 1, 1953, were to be ten year irrevocable trusts (R. 84). Richard H. Miers, the trustee, testified that it was

intended that irrevocable trusts be created (R. 194). Frederick L. Botsford, a witness for the Respondent, an attorney licensed to practice law in California, who represented Mr. and Mrs. Flitcroft (R. 202), who prepared the trust agreements dated January 1, 1953 (R. 202), and was later a co-trustee and still was at the time of trial before the Tax Court (R. 211), verified the complaint in an action hereinafter described, entitled Botsford, et al. v. Will Flitcroft, Agnes D. Flitcroft and Robert A. Riddell, District Director of Internal Revenue, in which Complaint it was alleged:

"That Defendants Will Flitcroft and Agnes D. Flitcroft executed two Trust instruments dated the 1st day of January, 1953, of which Exhibits "A" and "B" attached hereto are copies, in which instruments Plaintiff Richard H. Miers was appointed Trustee.

"That it was intended by all parties, Article I of the Trust Agreements should read as follows:

'The Trustors shall have the right at any time, to add to this Trust other property acceptable to the Trustee, which additional property, upon its receipt and acceptance by the Trustee, shall become a part of the Trust Estate. This Trust is irrevocable.'

"The scrivener, by mistake, omitted to include in Article I above, the sentence:

'This trust is irrevocable.'

"That Plaintiffs, relying upon the accuracy of the scrivener, did not discover this omission until their

attention was drawn thereto several months later." (Exh 11).

Upon discovery of the scrivener's mistake the parties to the Trust Agreements amended each of them on the 30th day of July, 1954, by adding thereto, the words "This trust is by the trustors, hereby expressly made irrevocable" (Exh. 11, pp. 25, 26).

On or about November 7, 1958, Frederick L. Botsford and Richard H. Miers, as trustees of the Flitcroft Trusts, Johnel A. Flitcroft and William R. Flitcroft, minors, by James Stevens, their Guardian Ad Litem, as plaintiffs, commenced an action in the Superior Court of the State of California in and for the County of Los Angeles, against William R. Flitcroft, Agnes D. Flitcroft and Robert A. Riddell, District Director of Internal Revenue (Exh. 11).

The Complaint filed, alleged, among other things, that it was intended by all parties to the Trust Agreements dated January 1, 1953, that Article I of the Trust Agreements should read as follows:

> "The Trustors shall have the right at any time to add to this Trust other property acceptable to the Trustee, which additional property, upon its receipt and acceptance by the Trustee, shall become a part of the Trust Estate. This Trust is Irrevocable." (Exh. 11).

The Complaint prayed for the following relief:

> "For costs of suit and for such further and other relief as to this Court may seem just in the premises." (Exh. 11).

The Defendant, Robert A. Riddell, District Director of Internal Revenue, petitioned for a removal of the action to the United States District Court for the Southern District of California (Exh. 11, p. 3). In the United States District Court the Defendant, Robert A. Riddell made a Motion to Dismiss the action as to himself on the grounds:

1. That the Court lacks jurisdiction over the person of this defendant.

2. That the Complaint does not state a claim upon which relief can be granted as to this defendant. (Exh. 11, p. 33).

On April 29, 1959, the District Court entered the following Order of Dismissal as to the Defendant, Robert A. Riddell:

> "IT IS HEREBY ORDERED that the action is dismissed with prejudice as to the defendant, Robert A. Riddell, on the ground that the complaint does not state a claim upon which relief can be granted as to this defendant, and upon the ground that since this appears to be an action for declaratory relief as to the defendant, Robert A. Riddell, with respect to a federal tax matter, the Court has no jurisdiction." (Exh. 11, p. 34).

The Plaintiffs in said action appealed from the District Court's Order of Dismissal to this Court (Exh. 11, p. 36). The United States Court of Appeals for the Ninth Circuit rendered a decision affirming the order of the District Court dismissing the

action as to the Defendant, Robert A. Riddell, District Director of Internal Revenue (283 F. 2d 298, 6 AFTR 2d 6185).

The action was then, by agreement of the remaining parties, remanded to the Superior Court (Exh. 12) Thereafter and on November 13, 1961, the Superior Court entered the following judgment:

> "The motion of plaintiffs' for judgment on the pleadings came on regularly to be heard the 13th day of October, 1961, ERNEST R. MORTENSON, and associate counsel, by ARN K. YOUNGMAN, appeared as counsel for plaintiffs and ROBERT P. REDDINGUIS appeared as counsel for defendants.
>
> "It appears and the court finds that the complaint states facts entitling plaintiffs to the relief therein prayed for and that the answer fails to state facts sufficient to constitute a defense to said complaint or any portion thereof, WHEREFORE IT IS ORDERED, ADJUDGED, AND DECREED that the Trust Agreements, dated January 1, 1953, executed by the defendants Will Flitcroft and Agnes D. Flitcroft, as trustors, and by the plaintiff Richard H. Miers, as trustee, copies of which are attached to the complaint on file herein marked as Exhibit A and B, be and they hereby are reformed in accordance with the express intent of the trustors and trustee so that the following sentence is added to the first paragraph of each of said Trust Agreements: 'This Trust is irrevocable.'

"IT IS FURTHER ORDERED AND DECREED that said Trust Agreements were irrevocable upon their date of execution, January 1, 1953, and the respective rights and obligations of the parties arising from said Agreements shall be governed accordingly.

"Dated: November 13, 1961 /s/ William E. Fox

Judge of the Superior Court"

(Exh. 13).

The Commissioner and the Tax Court have refused to recognize that the two trusts created by petitioners on January 1, 1953 were owners of a capital interest in the partnership of Western Hydraulic and for that reason attributed all of the partnership income to these petitioners in the calendar years 1954, 1955 and 1956 (R. 23, 24, 37, 217-247).

About November 1, 1953, Western Hydraulic and Service Company moved into a new plant located at 1510 West 131st Street (R. 226). The building was originally owned 60% by petitioners and 40% by John O. Best, an unrelated party (R. 226). On October 1, 1953, the petitioners created a joint trust for their two children in which Richard H. Miers was also named as trustee (R. 226, 227). At that time petitioners conveyed their 60% interest in the premises at 1510 West 131st Street to said trust (R. 227), and assigned their interest, as lessors, under the lease of the premises to said trust (R. 227). Western Hydraulic and Service Company paid a rent of $1600.00 per month for the use of the new premises, $960.00 to

the children's joint trust and $640.00 to John O. Best (R 226).

The joint trust agreement of October 1, 1953 provided that the trust should terminate on October 6, 1963. As originally drawn the trust agreement did not expressly provide that the trust was irrevocable (Exh. 20). It was amended on July 30, 1954 to read: "This trust is, by the trustors, hereby expressly made irrevocable." (R. 57, Exh. 21).

The Commissioner of Internal Revenue, in each of the calendar years here involved, held that the rent paid by the partnership transacting business under the fictitious name of Western Hydraulic & Service Company to the Johnel Ann and William R. Flitcroft Trust, was not a deductible business expense of the partnership and accordingly included those amounts in the earnings of the partnership and in the petitioners' distributive shares of the partnership earnings for those years (R. 21, 23, 40). The Tax Court upheld the Commissioner on this point without discussing the question of whether the rent paid was a deductible business expense of the partnership (R. 246).

SUMMARY OF ARGUMENT

1. The Trusts need not be irrevocable for ten years or more under the decision of Commissioner v. Clark (1953), CA-7, 202 F. 2d 94.

2. The Trusts were expressly irrevocable during all the tax years involved in this case.

3. In any event, the Trusts were expressly irrevocable from their inception either by virtue of the provisions of §2250, Civil Code of California, because they were created for the benefit of the grantors, or by virtue of the order of the Superior Court in and for the County of Los Angeles entered November 13, 1961 decreeing "that said Trust Agreements were irrevocable upon their date of execution, January 1, 1953".

4. The co-partnership, Western Hydraulic and Service Company was entitled by §23(a) of the Internal Revenue Code of 1954 to deduct the rent paid on its business premises from its gross income.

ARGUMENT

I.

THE TRUSTS CREATED BY THESE PETITIONERS ARE SHOWN BY THE EVIDENCE AND THE FINDINGS OF THE TAX COURT TO IN EVERY INSTANCE HAVE HAD A LIFE IN EXCESS OF TEN YEARS AND TO HAVE, BY THE TERMS OF THE TRUST INSTRUMENTS, BEEN IRREVOCABLE AFTER JULY 30, 1954. EVEN ASSUMING, ARGUENDO, THAT THOSE TRUSTS WERE IRREVOCABLE FOR A PERIOD OF LESS THAN TEN YEARS THEY WERE IMPROPERLY TAXED TO THE GRANTORS FOR THE CALENDAR YEARS 1954, 1955 AND 1956, UNDER THE RULE ANNOUNCED IN THE CASE OF COMMISSIONER vs. CLARK, (1953) CA-7, 202 F. 2d 94. THE CLARK CASE HOLDS THAT THE TEN YEAR REQUIREMENT IS UNCONSTITUTIONAL.

There are two facts found by the Tax Court with respect to which there is no controversy and no room for controversy under the stipulated facts. First: All of the trust agreements expressly

provided at the time they were executed that the trust thereby created should exist for a term of more than ten years. Second: On or after July 30, 1954, all of the trust agreements, by virtue of an amendment agreed upon by the trustors and trustees, provided "This Trust is by the trustors, hereby expressly made irrevocable". A third fact found by the Tax Court and supported by the evidence must be accepted as true. It is that the transactions were not shams and there was clearly a transfer of the corpus of the two individual trusts (hereinafter referred to as A and B Trusts) to independent trustees (R. 234).

The Commissioner of Internal Revenue contended that the income of the trusts (A & B) was taxable to the petitioners under §673(a) of the Internal Revenue Code of 1954 if they were irrevocable trusts for a period of less than ten years. The Tax Court concluded, erroneously the petitioners contend for reasons hereinafter asserted, that each trust was revocable until July 30, 1954. Since this review is concerned with no taxable year ending before July 30, 1954, §676(a) of the Internal Revenue Code of 1954 can be disregarded for the reason that there is no contention present that the grantors had power to revest themselves with any portions of the trusts after July 30, 1954.

After it had reached what the petitioners contend was an erroneous conclusion that the trusts were revocable prior to July 30, 1954, the Tax Court still was confronted with the fact that Gaylord v. Commissioner, 153 F. 2d 408 (CA-9), 34 AFTR 880, affirming 3 T. C. 281 and Krag v. Commissioner, 8 T. C. 1091,

upon which it relied, did not pass on the question of whether the trusts as amended were still to be treated as revocable trusts for income tax purposes (R. 240). The Tax Court stated "Neither party has called our attention to any case dealing with this question in applying the provisions of the income tax laws." (R. 242). The Tax Court resolved this question by concluding, erroneously the petitioners contend, that the trusts were at no time irrevocable for a period of over ten years and therefore the income was taxable to the grantors under the provisions of §673(a) of the Internal Revenue Code of 1954. The Tax Court also accepted the Commissioner's contention that the provisions of §39.22(a)-21(c) Regs. 118 applied to the taxability of the income of the joint trust (C trust), for the period from July 30, 1954 to December 1, 1954 (R. 247).

The Tax Court's reasoning at this point was confronted by the opinion of the Court of Appeals for the Seventh Circuit in the case of Commissioner v. Clark (1953), 202 F.2d 94, 43 AFTR 259, affirming 17 T.C. 1357, which had been cited by the petitioners. In that case the Circuit Court held the provisions of §29.22(C)-21, Regs. 111, which are substantially the same as those of §39.22(a)-21(c), Regs. 118, to be invalid. The Circuit Court said:

> "The Commissioner, in support of his determination of deficiencies for 1946, relies solely upon Treasury Regulation 111, promulgated under the Internal Revenue Code on December 29, 1945, and applicable to taxable years commencing January 1, 1946. The pertinent portion of this regulation is §29.22(c)-21, which provides:

'Income of a trust is taxable to the grantor where the grantor has a reversionary interest in the corpus or the income therefrom which will or may reasonably be expected to take effect in possession or enjoyment -

'(1) within ten years commencing with the date of the transfer * * * '.

"Petitioners attack the regulation upon three grounds: (1) its application to the instant situation would give it a retroactive effect and, in any event, the trusts are not merely for nine years, as asserted by the Commissioner, but are ten-year trusts; (2) the regulation is unreasonable and arbitrary and, therefore, void, and (3) it is unconstitutional inasmuch as it deprives petitioners of their property without due process, that is, without a hearing on the issues existing between the taxpayer and the Commissioner and which arise because of the deficiencies asserted by the Commissioner."

202 F. 2d 94, 43 AFTR 259.

The Tax Court sought to distinguish the Clark case by saying that in the present case the regulation involved was in existence at the time of the creation of the joint trust (C Trust), on October 1, 1953. From this the Tax Court concluded that the income of the joint (C Trust) for the period from July 30, 1954 to December 1, 1954, was taxable to the petitioners.

Before proceeding with a discussion of the Clark case the

petitioners pause to point out that the Commissioner has never determined that the income of the joint (C Trust) created on October 1, 1953 was taxable to the grantors at any time. He simply disallowed the partnership, Western Hydraulic, a deduction for the rent it paid that trust. The matter of allowing a deduction for the rent will be discussed in the final chapter of this brief.

The petitioners do urgently contend in this brief that the two trusts (A and B) created on January 1, 1953, were at no time revocable trusts. They also contend that under the rule laid down in the case of Commissioner v. Clark, supra, the income of those trusts would not be taxable to the grantors for the calendar years 1954, 1955 and 1956 even if it were conceded that the trusts were revocable prior to their amendment on July 30, 1954. The Clark case involved interpretation of the provisions of §39.22(c)-21 of Regs. 111. That section of the regulations provided:

> "Income of a trust is taxable to the grantor where the grantor has a reversionary interest in the corpus or the income therefrom which will or may be reasonably expected to take effect in possession or enjoyment -
>
> "(1) Within ten years commencing with the date of the transfer * * * ."

This section of Regulations was replaced by §39.22(a)-21(c)(1) of Regs. 118, effective January 1, 1953, which reads:

> "Income of a trust is taxable to the grantor where the grantor has a reversionary interest in the corpus * * *

which will or may reasonably be expected to take effect in possession or enjoyment.

"(1) Within ten years commencing with the date of transfer * * * ."

This regulation was in effect when on August 16, 1954 Congress enacted §673(a) of the Internal Revenue Code of 1954, which provided:

"The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if as of the inception of that portion of the trust, the interest will or may reasonably be expected to take effect in possession or enjoyment within ten years commencing with the date of the transfer of that portion of the trust."

The report of the House Ways and Means Committee and that of the Senate Finance Committee, found at pages 4553 and 5007 of Vol. 3, 1954 United States Code, Congressional and Administrative News, with respect to §673(a) of the Internal Revenue Code of 1954 both state:

"This section contains the rules applicable to the short term trust containing the provision for a reversion to the grantor. The section enacts in statutory form provisions in lieu of those contained in §39.22(a)-21(c)

of Regs. 118 * * * ."

The current regulation, §1.673(a), first filed on December 19, 1956, as Treasury Decision 6217, contains substantially the same provisions.

It will assist in the discussion of the Clark case to compare the Flitcroft trusts, A, B and C with the Clark trust in respect to the time intervals between the time the trust instruments were amended and the date the agreements expired.

A Trust	B Trust	C Trust	Clark Trust
8 years	8 years	9 years	9 years
5 months	5 months	3 months	

The Flitcroft trusts, A and B, were to operate under written trust instruments making them expressly irrevocable for eight years and five months and the C Trust for nine years and three months after the amendments of July 30, 1954. The Clark trust was to operate for nine years after its trust agreement was amended to extend its already irrevocable term from five years to ten years. All four of the trusts were expressly irrevocable trusts during the years in which the disputed deficiencies arose. It was clear that the grantors of the Flitcroft trusts did not have a reversionary interest that could be reasonably expected to take effect in possession or enjoyment within ten years commencing with the dates of the respective transfers to the trusts at any time after July 30, 1954, within the meaning of §39.22(a)-21(c)(1) of Regulation 118. It is significant that the Commissioner did not determine that the

income of the Flitcroft C Trust, was taxable to the grantors

In its opinion the Tax Court held that in the instant case the regulation involved was in existence at the time of the creation of the joint trust (C Trust). But the income of that trust was not attacked by the Commissioner. However, the regulation §39.22(a)-21(c)(1) of Regulations became effective on January 1, 1952, and was also in existence on January 1, 1953 when the individual trusts, A and B, which are under attack, were created. Section 673(a) of the Internal Revenue Code of 1954 had not been enacted when any of the trusts were created, nor was it in effect when the trust instruments were amended on July 30, 1954. See also §7851(a)(2)(B) of the Internal Revenue Code of 1954, which preserves rights in existence when that Code was enacted. But the fault of retroactivity was not the only one found with the Clark trust by the Tax Court and the Court of Appeals for the Seventh Circuit in Commissioner v. Clark, supra.

The Court of Appeals also decided that the regulation was invalid because it violated the provisions of the Fifth Amendment of the Constitution of the United States when it created a conclusive presumption that the grantor of a trust was the owner of the corpus and income derived from the corpus for the sole reason that the trust had a duration of less than ten years. The Seventh Circuit also pointed out that even Congress would be without power to create such a conclusive presumption. Since then Congress has made an attempt to do so by the enactment of §673(a) of the Internal Revenue Code of 1954 upon which the Commissioner and Tax Court

here rely. No case contrary to that of Commissioner v. Clark, supra, has been found. It is submitted that both §39 22(a)-21(c), Regs. 118 and §673(a), Internal Revenue Code of 1954 were and are unconstitutional and void.

The Court of Appeals in the Clark case also held §29. 22(c)-21 of Regs. 111 to be void because it was arbitrary and unreasonable. It is submitted that §39. 22(a)-21(c) contained exactly the same fault and was also void.

The Tax Court found it to be a fact that the corpus of the Flitcroft A and B trusts was transferred to independent trustees who controlled the corpus of those trusts and that the transactions were not shams (R. 234). This finding leaves no room for the application of the case of Clifford v. United States (1940), 309 U.S. 331.

The petitioners contend in the following chapter of this brief that because of the limitations placed upon the operation of §2280 of the Civil Code of California by §2250 of that Code neither of the Flitcroft trusts, A and B, were ever as a matter of fact or law, revocable. Aside from that contention it is submitted that it follows from the facts found by the Tax Court that upon the authority of Commissioner v. Clark, supra, no part of the income of trusts A and B was taxable to the grantors in the calendar years 1954, 1955 and 1956 for the reason that the trust instruments themselves, at all times after July 30, 1954, expressly provided that the trusts were irrevocable.

II.

THE TRUSTS CREATED FOR WILLIAM R. FLITCROFT AND JOHNEL ANN FLITCROFT BY THEIR PARENTS, THE APPELLANTS HEREIN, ON JANUARY 1, 1953, WERE PARTLY FOR THE BENEFIT OF THE TRUSTORS AND THEREFORE NOT REVOCABLE UNDER THE PROVISIONS OF §2280 OF THE CIVIL CODE OF CALIFORNIA BECAUSE OF THE LIMITING PROVISIONS OF §2250 OF THAT CODE.

This is a family partnership case in which the Tax Court has, upon abundant evidence, found as a fact that half of the original partnership's assets were transferred to a trustee for two trusts that the petitioners created for their children on January 1, 1953; that the trusts then entered a new partnership agreement with the trustors to conduct the business of Western Hydraulic and Service Company, that these transactions were not shams; that the trustees were unrelated and independent, that capital was a material income-producing factor in the partnership, Western Hydraulic, that the grantors received none of the trust income and that the trustee performed services for the partnership. These trusts will hereinafter be called A and B trusts in this brief. The central question presented to this Court on Review is that of whether the two trusts created for petitioners' children were each the owner of a one-fourth capital interest in the family partnership. If those trusts were the owners of a half interest in the partnership during the taxable year involved, the law is well established that half of the partnership income must be attributed and taxed to them and not to these petitioners. Poggetto v. United States (1962), CA-9,

291 F. 2d 586, 10 AFTR 2d 5341.

Section 704(c)(1) of the Internal Revenue Code of 1954 provides: In §7 of the Senate Finance Committee Report on H. R 4473 Proposed Revenue Act of 1951, dealing with family partnerships, and in the Ways and Means Committee Report on the same subject the following pertinent comment is found:

"2/ In Sec. 7 of the Senate Finance Committee Report on H. F. 4473, Proposed Revenue Act of 1951, dealing with family partnerships, and in the Ways and Means Committee Report on the same subject, the present confused state of the law is thus summarized:

" 'Section 339 of your committee's bill is intended to harmonize the rules governing interests in the so-called family partnership with those generally applicable to other forms of property or business. Two principles governing attribution of income have long been accepted as basic: (1) Income from property is attributable to the owner of the property; (2) income from personal service is attributable to the person rendering the services. There is no reason for applying different principles to partnership income. If an individual makes a bona fide gift of real estate, or of a share of corporate stock, the rent or dividend income is taxable to the donee. Your committee's amendment makes it clear that, however the owner of a partnership interest may have acquired such interest, the income is taxable to the owner, if he is the real owner.

If the ownership is real, it does not matter what motivated the transfer to him or whether the business benefited from the entrance of the new partner.

" 'Although there is no basis under existing statutes for any different treatment of partnership interests, some decisions in this field have ignored the principle that income from property is to be taxed to the owner of the property.' "

The Commissioner attacked the partnership on the ground that trusts A and B should not be recognized for income tax purposes. His arguments before the Tax Court disclose that the sole basis for refusing to recognize trusts A and B as partners in Western Hydraulic and Service was that for the period of time elapsing between the creation of the trusts on January 1, 1953 and July 30, 1954 (one year and seven months) the trust instruments themselves did not expressly provide that the trusts were irrevocable. It has been pointed out in the previous chapter of this brief that under the holding of the case of Commissioner v. Clark (1953), 202 F. 2d 94, 43 AFTR 259, trusts A and B were valid and entitled to recognition even upon the Tax Court's finding that the trust agreements were by their express terms irrevocable only after their amendment on July 30, 1954. However, the petitioners submit that the trusts were, in fact, irrevocable trusts at all times, both before and after their amendment under the applicable law of California.

The Tax Court's opinion cites the provisions of §2280 of the Civil Code of California to support its conclusion that the A and B trusts were revocable and the petitioners, rather than the trusts, the owners of all of the partnership capital, within the intent of §676(a) and §673(a) of the Internal Revenue Code of 1954 during the calendar years 1954, 1955 and 1956. In so doing it is submitted the Tax Court committed the error of refusing to follow the law of California as found in §2250 of the Civil Code of California and the judgment of the Superior Court of the State of California entered in the case of Botsford, et al. v. Flitcroft on November 13, 1961. The Tax Court cited the decision of this Court in Gaylord v. Commissioner (1946), 153 F. 2d 408, 34 AFTR 880, affirming 3 T. C. 281 and Erik Krag (1947), 8 T. C. 1091 in support of its action. The petitioners do not here quarrel with those decisions. They do urge that they do not apply.

In the Gaylord and Krag cases, supra, title to the trust corpus was also vested in the trustee, as §2250 of the Civil Code of California requires it to be as a condition precedent to the application of §2280 contained in the same chapter of that Code. In the A and B trusts title to the trust property was also transferred to the trustee.

In the Gaylord and Krag cases the trustor and the trustee were, in each case, the same person. In the pending cases Richard H. Miers and later Frederick L. Botsford were found by the Tax Court to be independent and unrelated trustees. In the Gaylord and Krag cases the grantors received no benefit from the execution of

the trust agreements. In the Flitcroft cases the trustors expected to and did obtain and retain the valued services of Richard H. Miers in the partnership business of Western Hydraulic and Service Company. That was a business benefit to the trustors. Pike v. United States (1956), CA-9, 231 F. 2d 515, 49 AFTR 515, 519. The Gaylord and Krag trusts were passive trusts holding nothing but shares of corporate stock and not involved in any partnership activities. The Flitcroft trusts held half of the capital and through their trustee actively participated as general partners in the very active partnership business of Western Hydraulic and Service Company. The Flitcroft trust instruments did provide in express terms that the trusts were irrevocable during the years here in question. The Gaylord and Krag trust instruments did not so provide and gave no room for the rule of Commissioner v. Clark, supra, to operate.

It is submitted that the trusts are not the same kind of trusts as those involved in the Gaylord and Krag cases, upon which the Tax Court predicates its opinion. Nor are they trusts to which the provisions of §2280 of the Civil Code of California apply for the reason that the grantors are shown to have received a benefit from the creator of the trusts. In the Gaylord and Krag trusts no benefit to the trustors followed from their creation and in that respect they met the second requirement of §2250 of the Civil Code of California and were accordingly to be considered revocable because of §2280 contained in the same chapter of that Code. The A and B trusts were not passive trusts; they participated through the trustee,

as general partners in the grantors' very active business of Western Hydraulic. That was a consideration or benefit flowing to the trust grantors. Further, there is a statutory presumption that a written contract and the A and B Trust Agreements were in writing, is supported by a good and sufficient consideration. Section 1614, California Civil Code; Blonder v. Gentile (1957), 149 Cal. App. 2d 869, 874, 309 P. 2d 147. The second requirement of §2250 was not met.

It is submitted that §2280 of the Civil Code of California did not apply to the A and B Trusts for the reason that §2250 of that Code limits the provisions of §2280 found in the same chapter II of the California Code to trusts in which the trustor derives no benefit.

The California courts have construed the word "voluntary" as used in §2280 of the Civil Code of California not to mean a "voluntary" trust in the broad sense found in §2216, but in the restricted sense of a trust created freely and without a valuable consideration or legal obligation. Touli v. Santa Cruz County Title Co. (1937), 20 Cal. App. 2d 495, 497; 67 P. 2d 404. In that case the California Court of Appeal used the following apt language (20 Cal. App. 2d 499):

> "The judgment must be reversed for these reasons:
>
> "(1) Section 2280 of the Civil Code, which permits the revocation of a trust 'unless expressly made irrevocable by the instrument' relates only to a 'voluntary' trust created without a valuable consideration passing to the trustor, and

does not apply to a deed of trust giving as security for the payment of an obligation. This follows from a consideration of the legislation as a whole. The original section was based on Field's Draft of the New York Civil Code, section 1209, and was enacted in 1872 when a deed of trust such as that involved here was 'both in legal effect and in theory' deemed to be a mortgage with a power of sale and differed 'not at all from a mortgage with a power of sale'. (Bank of Italy Nat. T. & S. Assn. v. Bentley, 217 Cal. 644, 654 [20 Pac.(2d) 940].) The expression 'voluntary' trust was first used in the section when it was redrafted by the amendment of 1931. At that time the distinction between an ordinary express trust and the common deed of trust given as security for an obligation was clearly defined in the California decisions and was well known to the law-makers. A voluntary trust was defined in section 2216 of the Civil Code as 'an obligation arising out of a personal confidence reposed in, and voluntarily accepted by, one for the benefit of another'. But this section was also enacted in 1872 and was based upon Field's Draft of the New York Civil Code, and hence the legislature could not have had in mind a trust identical to 'a mortgage with a power of sale'. Webster's New International Dictionary under the heading 'voluntary-law' gives this definition: 'Acting, or done, of one's own free will without valuable consideration, acting, or done, without any present legal

obligation to do the thing done.' It was in the latter sense that the word 'voluntary' was used in the amended section, otherwise it would not have been coupled with the word 'revocable' without reservation. The word 'revoke' literally means to 'call back'. It is synonymous with 'rescind', to 'recall' and 'to cancel'. It does not mean 'repudiation'. A deed of trust given to secure an obligation is a contract, the right to rescind which is granted and limited by express provisions of the Civil Code to which we will hereafter refer. It must follow, therefore, that when section 2280 was drafted to permit the revocation of a 'voluntary' trust, that expression was not used in the broad sense found in section 2216, but in the restricted sense of a trust created freely and without a valuable consideration or legal obligation. Otherwise the legislature would have restricted the revocation, or rescission, to the general equitable safeguards placed upon mortgages and contracts in general.

"This view is fortified by a consideration of the structure of the code in which these sections appear. Section 2280 is a part of article V of chapter 2 of the article on trusts. Section 2250, which is in article I of that chapter reads: 'The provisions of this chapter apply only to express trusts, created for the benefit of another than the trustor, and in which the title to the trust property is vested in the trustee; not including, however,

those of executors, administrators, and guardians, as such.' A deed of trust such as we have here is created for the benefit of the trustor and the named beneficiary. (Humboldt Sav. Bank v. McCleverty, 161 Cal. 285, 290 [119 Pac. 82]; Ainsa v. Mercantile Trust Co., 174 Cal. 504, 510 [163 Pac. 898]; Atkinson v. Foote, 44 Cal.App. 149, 156 [186 Pac. 831]; Kellum v. San Mateo County Title Co., 127 Cal.App. 276, 279 [15 Pac.(2d) 876]; 25 Cal.Jur., pp. 11, 12, 42.) The author in California Jurisprudence at page 11 correctly concludes that the ordinary deed of trust 'is not, therefore, governed by the chapter of the Civil Code beginning with section 2250, as that refers to those trusts which are entirely for the benefit of third persons, wherein the title wholly passes to the trustee, there being nothing to be done for the benefit of the trustor -- nothing left in or to be returned to him.' Hence, a deed of trust given as security for an obligation is not a trust 'created for the benefit of another than the trustor', but is one created for the benefit of the trustor as well as for the benefit of the named beneficiary."

"The deed of trust is a contract wherein mutual obligations are imposed upon the trustor, the trustee, and the beneficiary. If §2280 could be applied on any theory to such a deed of trust, the revocation permitted by that section is nothing more than a rescission of this contract. As such it is controlled by the provisions of §1689 et seq.

of the Civil Code and particularly by the provisions of §1691, sub-division 2, declaring that the actor must 'restore to the other party everything of value which he has received from him under the contract'."

It is true, as the Tax Court states in its opinion (R. 238), that the Touli case, supra, was discussing an ordinary deed of trust given as security for a loan. The Tax Court then immediately concluded as a matter of law that the A and B trusts here involved were voluntary express trusts for the benefit of another than the grantor because they did not also involve a trust deed or loan of money. It is submitted that it does not follow at all that merely because the A and B trusts were not also trust deeds or security for a loan they were voluntary express trusts for the benefit of another than the grantor. The Tax Court says "the trusts themselves state that they are without consideration". The record discloses that the trust agreements state there was no consideration on the trustor's part. But the Tax Court had in the opening paragraph of its opinion correctly concluded that, as a matter of law, the partnership agreement and trust agreements, all dated January 1, 1953, were part of the same transaction and are required to be read together (R. 234). This first conclusion is strongly supported by the evidence in the record and by the facts which the Tax Court has found. There lay the benefit to the grantors. They were obtaining and retaining the valuable services of an employee in their already existing business, Western Hydraulic &

Service Company, by substantially the same procedure that was followed in the case of Pike v. United States, supra. A written instrument is presumptive evidence of a consideration. Section 1614, Civil Code of California. This presumption is disputable but the burden of showing want of consideration lies with the parties seeking to invalidate or avoid the instrument. Blonder v. Gentile, supra.

In further support of its conclusion that the A and B trusts were voluntary express trusts for the benefit of another than the grantor the Tax Court said:

> "The evidence fails to show any benefit to petitioners of Miers' work for Western Hydraulic which was different after the creation of the trusts from before. Both before and after the creation of the trusts Miers did work of an accounting nature for Western Hydraulic at a fee of $60 per day. The record does not show any other activities engaged in by Miers in connection with the partnership except his consultation on partnership matters with petitioners. There is no evidence to show that the consultations were of any benefit to petitioners or that they were not solely in the interests of the trusts." (R. 239).

These are surprising conclusions and appear to have been made by the Tax Court either because it overlooked the facts found by it or else for the sole purpose of trying to force the present case to fit the mold in which the cases of Gaylord v. Commissioner (1946), CCA-9, 153 F. 2d 408, 34 AFTR 880, affirming 3 T. C. 281 and

Erik Krag v. Commissioner (1947), 8 T. C. 1091 were cast The same judge, in the same cases and earlier in the very same opinion filed by the Tax Court in the Flitcroft cases had found as facts that:

> "During the years 1953 through 1956 Miers spent most of his time in connection with the business of Western Hydraulic. He took charge of production control, accounting, contract negotiations, renegotiation of government contracts, and cost records. He also handled labor relations for the partnership and served as its controller, as well as working with the sales and engineering departments on the submission of bids for contracts. He hired office personnel and dealt directly with customers of Western Hydraulic." (R. 225, 226).

The evidence in the record and the facts found therefrom by the Tax Court of benefits to petitioners from Miers' services are impressive and do not support the conclusion that no benefit to the petitioners from Miers' work was shown.

The Tax Court has found as a fact that prior to the formation of the A and B trusts in controversy and the related partnership between the petitioners and those trusts on January 1, 1953, Will Flitcroft worked long hours, six and sometimes seven days a week (R. 220). Will Flitcroft testified that "it was a question of getting someone in there to do a good job with me or break my health down (R. 77). The general nature of the partnership agreement was that Mr. Miers was to devote all of the time he could devote to

the business which he probably did about ninety-nine per cent of his time and he had a few other accounts that he let go and devoted the bulk of his time to Western Hydraulic and Service Company and helping me to operate a more efficient and better business that could progress in the future (R. 79, 80). He took a terrific load off my back." (R. 20). It is submitted that the grantors of the A and B trusts gained a benefit for themselves when, by the execution of the trust and partnership agreements, they obtained and retained the sorely needed services and ability of Richard H. Miers in their partnership, Western Hydraulic. The benefit to the trustors may well have been much larger than the loan of money obtained by the trustors under the trust deed in the Touli case, supra. In either event §2280 of the Civil Code of California would not apply to make the trusts irrevocable for the sole reason that the trust agreements did not expressly state that the trusts were irrevocable. The trusts were irrevocable because made for the benefit of the grantors. Section 2280, Civil Code of California; Touli v. Santa Cruz County Title Company, supra. They could only be terminated by rescission -- never by revocation. Touli, supra.

Richard H. Miers, the trustee, testified as follows:

> "So I volunteered my services and Mr. Flitcroft took me up on it. And we devised these trusts, set up the partnership, primarily for expansion purposes so that we could expand the operation. * * * Shortly after they settled the situation in Korea the volume decreased somewhat, but then it turned back up and doubled." (R. 88).

It is submitted that the doubling of the business of the partnership, Western Hydraulic, was also a benefit or consideration flowing to the grantors of the A and B trusts which, by virtue of the provisions of §2250 of the Civil Code of California, prevented those trusts from being revocable under the provisions of §2280 of the Code. A voluntary trust created without a benefit or consideration to the grantor may be revoked by the grantor. But where the grantor does receive a benefit or consideration from the creation of the voluntary trust he is not at liberty to revoke it. Section 2250 California Civil Code. In the latter circumstances he might, where some of the conditions enumerated in §1689, et seq. of the California Civil Code exist, rescind the trust agreement. There is a vast legal difference between revoking and rescinding a trust agreement. That is to say the grantors had received a consideration, a promise of the services of Miers in the business of Western Hydraulic, and could therefore not revoke the trust. The trusts could only be terminated in less than ten years by a rescission brought about under §1691(2) of the California Civil Code. Touli, supra, is submitted that the Tax Court was confronted with the possibility that the trusts might be rescinded for the causes set forth in §1689 of the Civil Code of California but not the grantor's power to revoke them under §2280 of that Code. That possibility of rescission is not the same thing as the power to revoke, of which §676(a) of the Internal Revenue Code of 1954 treats. The contingent possibility of rescission was not a reversionary interest held by the grantors of the A and B trusts within the meaning of §673(a) of

the Internal Revenue Code of 1954 and §39.22(a)-21(c), Regs. 118

The Tax Court appears to have been of the impression that all the compensation Miers, the trustee, received for his activities on behalf of Western Hydraulic was his accountant's fee of $60 per day (R. 239). This is not true. Article VI of the respective trust instruments provided that he should receive 4% of the first $25,000 of trust income, 37% on the next $15,000 and 2% on the balance of such income each year from each trust (Exs. 5, 6, 20) Computation made from the net income reported by A and B trusts as shown by the findings of the Tax Court discloses that the trustee fees would amount to approximately $1,593.17, $1,134.52 and $1,386.75 for the calendar years 1954, 1955 and 1956, respectively (R. 218). The trust income consisted principally of their distributive share of the partnership income of Western Hydraulic (Pet. Exs. 25, 26, 27, 28, 37, 38, 39, 40, 41, 42, 43, 44). Following December 1, 1954, Frederick L. Botsford was a co-trustee and shared the trustee's fees (R. 211). Miers was not an employee of the partnership but he did serve the interests of the grantors of A and B trusts in the conduct of the business of Western Hydraulic. His trustee's fee was a form of incentive pay for duties, other than those of an accounting nature, performed in the partnership venture and was indirectly received from Western Hydraulic.

The Tax Court has concluded that as a matter of law the judgment of the California Court of November 13, 1961 declaring the A and B trusts of January 1, 1954, to have been irrevocable upon their date of execution, January 1, 1953, was collusive. It

next concluded the trusts were revocable until their amendment on July 30. 1954. This conclusion begs the question at issue. Petitioners contend that on the authority of §2250 of the California Civil Code the trusts were at no time revocable because the grantors received a benefit by their creation. They also contend, upon the authority of Commissioner v. Clark, supra, that since the trusts were, by amendment, made expressly irrevocable during the calendar years 1954, 1955 and 1956 they must be recognized as owners of a partnership interest in Western Hydraulic during those years. The Tax Court ultimately concluded that the trusts were at no time irrevocable for a period of over ten years and therefore the income from them was taxable to the grantors (R. 237). The petitioners take the position that the amendments of the trust instruments on July 30, 1954, has nothing to do with the question of whether the trusts were irrevocable at their inception. Further along in its opinion the Tax Court said: "Petitioners conclude from this that since the trusts here involved were amended or reformed to make them expressly irrevocable on July 30, 1954 and have at all times been for terms exceeding ten years that they were irrevocable trusts for terms of over ten years during the calendar years 1954, 1955 and 1956" (R. 245). At this point the Tax Court simply failed to grasp the arguments presented to it. Petitioners' contention was and is, first: The trusts were irrevocable from their inception on January 1, 1953, because a benefit accrued to the grantors. Second, the judgment of the Superior Court of California of November 13, 1961, reformed the

trust instruments as originally drawn on January 1, 1953 (not the trust instruments as they read after their amendment on July 30, 1954), to express the original intent of the parties to the trust instruments that they provide "This trust is irrevocable". It is not contended the judgment operated to make an irrevocable trust out of one that was originally revocable by the grantor. It is contended the grantors never possessed the power to revoke because of the limitations §2250 of the Civil Code of California places upon the operation of §2280. The judgment of reformation merely reformed the contract to read as the parties always intended it to read. It incidentally expressed the intention of the California legislature as manifested in the provisions of §2250 of the Civil Code of that State, that trusts in which the grantors receive a benefit are at all times irrevocable. It is the rule under the California law that reformation of an instrument relates back to the date of the instrument and binds everyone but interim purchasers for value. Section 3399, California Civil Code; Baines v. Zuieback (1948), 84 Cal. App. 2d 483, 191 P. 2d 67. The California law is to be followed, Erie Railroad Co. v. Tompkins (1938), 304 U.S. 64, reversing CA-2, 90 F. 2d 603.

There is a distinction under the California law between an action for Declaratory Judgment and one to reform a contract. The object of the former is to resolve a controversy and of the latter to correct a mistake of the parties (or the scrivener) to a written instrument. In the former it is a prerequisite to maintenance of the action that there be an actual controversy relating to the legal

rights and duties of the respective parties. Section 1060, California Code of Civil Procedure. In the latter it is not necessary that there be an actual controversy. A conceded mistake will suffice. Section 3399, California Civil Code. The language used by the Tax Court in the case of Erik Krag (1947), 8 T. C. 1091, indicates that it may not have been fully aware of the distinction between an action for declaratory relief and one for the reformation of a contract under the California statutes:

The Tax Court there said:

> "It is also true, as contended by petitioners, that the cited cases hold that decisions of state courts determining property rights are binding upon Federal courts. However, such rule applies only to a decision entered in a proceeding presenting a real controversy for determination. The decision must be on issues 'regularly submitted and not in any sense a consent decree'. Freuler v. Helvering, 291 U.S. 35, see also Francis Doll, 2 T. C. 276, affd., 149 F. 2d 239, certiorari denied, 326 U.S. 725; Tatem Wofford, 5 T. C. 1152, 1161-1163; Leslie H. Green, 7 T. C. 263, 274. In the suit herein involved there was no real controversy."

It justified this language with a citation from Freuler v. Helvering, 291 U.S. 35 and Sinopoulo v. Jones, supra. A reading of the opinion in Freuler does not disclose that the Supreme Court so held. The Tax Court appears to have quoted a contention that the Commissioner made and the Supreme Court rejected as being a

holding of the Court. However, the Supreme Court did make the following applicable statements in its opinion:

> "Moreover, the decision of that court, until reversed or overruled, establishes the law of California respecting distribution of the trust estate. It is nonetheless a declaration of the law of the state because not based on a statute, or earlier decision. The rights of the beneficiaries are property rights and the court has adjudicated them." (Emphasis supplied).
>
> " * * * We cannot seize on the form of the settlement made between the parties either to impugn the good faith and judicial character of the state court's decree, or to ignore the decree and its conclusiveness as to what was in fact and in law income distributable to the beneficiaries under the trust." 13 AFTR 838.

The prayer of the Complaint in the Superior Court asked both for a reformation of the trust instruments and a declaratory judgment adjudicating the respective rights of trustors and trustees under the trust instruments. The Superior Court gave judgment accordingly.

There is no statutory requirement in California that an actual controversy between the parties exist in an action for the reformation of a written instrument. Section 3399, California Civil Code. Section 1060 of the California Code of Civil Procedure does, on the other hand, provide that there must be an actual

controversy relating to the legal rights and duties of the respective parties before an action for Declaratory Relief may be maintained in the Superior Court. Section 1061 of that Code provides that "The Court may refuse to exercise the power granted by the chapter in any case where its declaration or determination is not necessary or proper at the time under all the circumstances." It is submitted that the Tax Court "impugns the good faith and judicial character of the State Court's decree" when it holds that the judgment for declaratory relief of November 13, 1961, was collusive.

In the first place it must be assumed that the Superior Court had determined in advance that an actual controversy existed else it would have exercised the power to refuse to entertain the action for declaratory relief given it by §1061 of the Code. In the second place the record before the Tax Court has led it to conclude that the A and B trusts were revocable prior to July 30, 1954. In the event the Tax Court is correct, the trustee, as a partner in Western Hydraulic, had already reported and paid more than $8,000 in Federal income taxes for the calendar years 1953 for each of said trusts which the trust did not owe (Pet. Exhs. 37, 41). Each trust was assessed with a deficiency in tax for that year of $975.79 (Pet. Exhs. 37. 41). Substantial sums had been reported and paid as income taxes by each trust for the years 1954, 1955 and 1956. If these payments were erroneous, because the trusts were revocable, the trustee needed to know that as it would be a fiduciary's duty to file a timely claim for the refund of any taxes he had erroneously paid for the trust. If, on the other hand, he filed a false claim he

would be subject to severe penalties. If the trusts were, in fact, irrevocable and the trustee failed to report their income for taxation he might be subject to criminal prosecution. The Federal taxes paid would have an effect on the California income taxes of the trusts. The taxes paid by the trusts might also have an effect upon the compensation to which the trustees would be entitled. These were reasons for seeking a declaratory judgment independent of its effect upon the Federal tax question presently in controversy between the grantors and the Government. There were no such independent reasons for seeking a declaratory judgment present in the Gaylord and Krag cases, supra.

It is submitted that the Tax Court erred in failing to find and conclude that the A and B trusts were ten year irrevocable trusts from the date of their creation on January 1, 1953 by virtue of the decision of the Superior Court of California so holding as well as the provisions of §2250 of the Civil Code of California.

III.

THE RENT PAID BY WESTERN HYDRAULIC AND SERVICE COMPANY TO THE JOHNEL ANN AND WILLIAM R. FLITCROFT TRUST ("C" TRUST) FOR THE USE AND POSSESSION OF ITS FACTORY PREMISES IS AN ALLOWABLE DEDUCTION FROM ITS GROSS INCOME FOR THE CALENDAR YEARS 1954, 1955 AND 1956 UNDER THE PROVISIONS OF §162(a)(3) OF THE INTERNAL REVENUE CODE OF 1954.

The Johnel A. Flitcroft and William R. Flitcroft Trust ("C" Trust) was the legal owner, and it held an assignment of

petitioners' interest as lessors of the property located at 1510 West 135th Street in Gardena, California (Pet. Exhs. 23, 36). Western Hydraulic and Service Company's manufacturing plant occupied the property under an agreement of lease dated September 15, 1953, in which Will Flitcroft, Agnes D. Flitcroft, John O. Best and Blanche Adams Best were the lessors. The rental provided for was $192,000.00 or $1,600.00 per month for a ten-year period following October 1, 1953 (Pet. Exh. 24). "C" Trust received a rent of $960.00 a month and John O. Best and wife received a rent of $640.00 a month from Western Hydraulic and Service Company (Tr. 106, 47).

Western Hydraulic and Service Company claimed and was allowed or disallowed the following rental deductions on its partnership returns of income (form 1065):

Year	Rental Claimed	Disallowed	Allowed
1953	$ 3,090.00	$ 2,690.00	$ 400.00
1954	22,392.83	11,520.00	10,872.83
1955	19,200.00	11,520.00	7,680.00
1956	19,200.00	11,520.00	7,680.00

(Exhs. 25-E, 26-F, 27-G, 28-H -- Deficiency Notice).

The rental paid by Western Hydraulic and Service Company was computed on the basis of eight cents a square foot per month. The figure was arrived at after a survey of the area was made and eight cents a square foot was found equitable (Tr. 105).

Section 162(a)(3) of the 1954 Internal Revenue Code provides

in so many words:

> "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including --
>
> "(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity * * * "

In the pending proceedings the respondent has held in his deficiency notices "that the rent paid by the partnership transacting business under the fictitious firm name of Western Hydraulic and Service Company to the Johnel Ann and William R. Flitcroft trust, * * * is not a deductible business expense of the partnership". His action simply ignores the provisions of the Internal Revenue Codes that a deduction shall be allowed for rentals paid for the use of property used in a trade or business. There is not a scintilla of evidence in the record that the leased property was not used in the business of the partnership or that a monthly rental of eight cents per square foot for the space used was not reasonable. There is uncontradicted evidence to the contrary. In fact, the respondent himself has allowed the portion of the rent (40% or 3.2 cents per square foot) which the partnership paid to the co-owners of the property, John O. Best and Blanche Adams Best. How he arrived

at a conclusion that all of the rent paid to two of the co-owners of the leased premises and none of the rent paid to the other one was a deductible business expense of the partnership is explained by neither the deficiency notices nor respondent's answers to the petitions herein.

The Tax Court refused to sustain the Commissioner's disallowance of rentals paid to a family corporation where that rent was fair and reasonable. Neel v. Commissioner (1954), 22 T.C. 1083; Rays Clothes, Inc. v. Commissioner (1954), 22 T.C. 1332. The deduction was allowed where the rent was paid to trusts for children of the lessee's controlling stockholders. Southern Ford Tractor Co. v. Commissioner (1958), 22 T.C. 822; Consolidated Apparel Co. v. Commissioner (1953), CA-7, 207 F.2d 580, 44 AFTR 515, reversing 17 T.C. 570.

It is submitted that the respondent's action in denying Western Hydraulic and Service Company a deduction for rent paid the Johnel Ann Flitcroft and William R. Flitcroft Trust in the taxable years 1954, 1955 and 1956 was arbitrary, unwarranted and contrary to the specific provisions of §162(a)(3) of the Internal Revenue Code of 1954.

CONCLUSION

It is respectfully submitted that the decisions of the Tax Court here on review should be reversed.

Dated: June 4, 1963.

Respectfully submitted,

ERNEST R. MORTENSON

EUGENE HARPOLE

By /s/ Eugene Harpole
EUGENE HARPOLE

Attorneys for Appellants

APPENDIX "A"

INDEX OF TESTIMONY AND EXHIBITS

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CERTIFICATE

I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit and that in my opinion this brief is in full compliance with those rules.

/s/ Eugene Harpole

EUGENE HARPOLE